VZCZCXRO5262
OO RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHFT #3103/01 2881259
ZNR UUUUU ZZH
O 141259Z OCT 08
FM AMCONSUL FRANKFURT
TO RUEHC/SECSTATE WASHDC IMMEDIATE 8261
INFO RUEATRS/DEPT OF TREASURY WASHDC IMMEDIATE
RUCNMEM/EU MEMBER STATES IMMEDIATE
RUCNFRG/FRG COLLECTIVE IMMEDIATE

UNCLAS SECTION 01 OF 02 FRANKFURT 003103

DEPARTMENT FOR EUR/AGS
TREASURY FOR LUKAS KOHLER/OFFICE FOR EUROPE AND EURASIA

SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON EU GM
SUBJECT: MERKEL AND STEINBRUECK UNVEIL FINANCIAL RESCUE PACKAGE

ENTIRE TEXT IS SENSITIVE BUT UNCLASSIFIED. NOT FOR INTERNET DISTRIBUTION

REF: (A) BERLIN 1389; (B) BERLIN 1366

This is a joint message from Embassy Berlin and AmConsulate Frankfurt.

¶1. SUMMARY: Chancellor Merkel and Finance Minister Steinbrueck announced the details of Germany's financial rescue packge October 13, following the French-led effort t coordinate efforts among the 15 euro zone member at this weekend's Paris summit. The so-called Financial Market Stabilization Fund gives the government unprecedented power, allowing it to guarantee 400 billion euros ($544 billion) in loans between banks, use up to 80 billion euros ($109 billion) for capital injections and use an undisclosed amount to buy up toxic assets. In return, the government will collect fees on guarantees and assume discretionary powers in the institutions that it funds directly.

¶2. Coming shortly after Germany's political guarantee of domestic savings deposits and its rejection of a euro zone rescue fund, the plan is a clear policy about-face, as Merkel and Steinbrueck came to accept the French position that a coordinated response with European partners was necessary following last week's sharp downturn in equity markets. Despite the change in position, the consensus between Merkel, Steinbrueck and Foreign Minister Steinmeier showed strong unity in the face of emergency in the CDU-SPD Grand Coalition, even with impending elections in September, 2009. Both houses of the parliament, will vote on the plan by the end of the week. Some resistance may appear among the state representations in the upper house, although passage appears likely. The German business community has responded enthusiastically to the government's actions. END SUMMARY.

State Guarantees to Restore Interbank Lending

¶3. The most significant element of the package, 400 billion euros in loan guarantees, aims to revitalize interbank lending by restoring confidence among banks and ending the near-total dependency on European Central Bank (ECB) liquidity operations for short-term funds. The government will charge at least a 2% fee for the guarantees which will be available on a 36 month basis to all banks. The state will set aside 20 billion euros ($27.2 billion), or 5% of the total guarantee, in its budget for potential losses stemming from defaults.

Recapitalization for Troubled Banks, Buy-Up of Toxic Assets

¶4. In the second part of the plan, the Finance Ministry will work with the Bundesbank (the German Central Bank) to inject up to 80 billion euros ($108.8 billion) in capital in banks and insurance companies. Troubled banks as well as insurance companies will be able to tap into the fund; in return, the government can take an

equity position through preferential shares or certificates of participation. The Finance Ministry and the Bundesbank will reserve the right to determine if an injection is in the state's interest and whether other market solutions have already been exhausted. The 80 billion is in addition to the 50 billion euros ($68 billion) supplied by the government and a banking consortium last week to recapitalize Hypo Real Estate. Additionally, the government can buy toxic assets from financial institutions, mirroring the U.S. Treasury Department's asset rescue plan, but details on the size of this part of the plan are still sketchy. The Bundesbank will manage a special vehicle to hold the assets.

¶5. The government will reserve the right to influence decisions within institutions that accept capital. The Finance Ministry will have the right to order institutions taking part in the plan to offer loans to corporations in the real economy. Goldman Sachs Germany Chief Economist Dirk Schumacher referred to this condition as "the government's quid pro quo" suggesting that the Finance Ministry will also use the fund as a way to stimulate the real economy. The plan also envisages a 500,000 euro ($680,000) ceiling on executive pay, a ban on bonuses, and a ban on dividends. Schumacher worried that banks have been "late to come for help" and that these provisions, if applied too harshly, would also discourage banks to reach out for assistance because of the high price to pay.

Fair-Value Accounting, Regulation and Burden-Sharing

¶6. The plan also calls on international authorities to relax mark-to-market accounting rules in cases where the value of the asset cannot be determined in time for third-quarter reporting, only

a few weeks away. It promises that German authorities will make improvements to supervision and regulation, including formalizing higher deposit insurance, by the end of 2008.

¶7. All financial institutions operating in Germany (including U.S.-subsidiaries) are eligible to take part in the plan. As envisaged, all aspects of the fund would expire at the end of 2009, at which point the government would take account of its gains or losses. State governments will assume 35% of the burden of the plan and any losses from state banks (Landesbanken). The state governments of Bavaria, Thuringia and Hesse have already expressed concern about this aspect of the package. The plan will be expedited through both houses of parliament as a bill by the end week, but approval in the upper house of parliament (Bundesrat) is not assured with the concerns raised by the individual states. Steinbrueck also conceded that the rescue package would upset the federal government's attempt to balance the budget by 2012.

Business and Banking Community Reacts Positively to Bail-Out

¶8. The rescue package was greeted with wide approval by the German business and banking community and leading economists. The Federation of German Employers' Associations (BDA) and the Association of German Chambers of Industry and Commerce (DIHK) welcomed the joint package of measures adopted by the euro-zone states as an "absolutely imperative step" to end the financial crisis. The President of the Association of German Banks (BdB), Klaus-Peter Mueller (who is also the supervisory board chair of Commerzbank) said the rescue package was important for two reasons: 1) the plan would depart from previous practices to tackle a problem only when it becomes apparent, i.e., on a case- by-case basis; and 2) the international financial crisis always has been an international crisis, requiring international answers. Mueller added that the talks on the margins of the IMF and World Bank meetings in Washington and the subsequent meeting at the European level, had brought major progress toward an internationally coordinated approach. Defying a deeply-rooted skepticism about state intervention, many German financial experts are now calling for a greater role of the government, major reforms to the German banking system, and even a European financial supervision authority.

Comment

¶9. The stabilization fund reflects an abrupt departure from the government's earlier "go-it-alone" strategy which rejected a European-wide rescue fund. Chancellor Merkel and Finance Minister Steinbrueck, however, increasingly recognized the need for coordinated European action after last week's precipitous drops in global financial markets. Their partnership demonstrates that the CDU and SPD, though political rivals in the run-up to the September 2009 elections, are still capable of effective joint governance. Capital markets in Germany have so far embraced the plan enthusiastically (with the DAX increasing by a whopping 11.4% Monday and a further gains Tuesday, but the plan's success is by no means assured as financial institutions may find they are unwilling or unable to accept the government's terms and fees. The plan, which still needs to pass in the parliament, also raises moral hazard concerns as the Finance Ministry assumes ownership stakes in financial institutions and, more importantly, decision-making powers in private entities. End Comment.
POWELL